Client Alert

Latham & Watkins Tax Department

Tax Reconciliation Act signed by US President on May 17 Contains Significant Changes that Impact Tax Planning

The Tax Increase Prevention and Reconciliation Act of 2005 (H.R. 4297) (the Act), signed into law by the United States President on May 17, 2006, contains a number of key provisions that affect international tax planning, corporate spin-off transactions and certain other areas. A number of provisions have a retroactive effect. It is important for taxpayers to determine the impact of these changes on their tax structuring and planning.

"This alert explores the effects of the Tax Reconciliation Act on international tax planning and corporate spin-off transactions, among other things."

CFC Changes

The Act includes two important provisions that deal with controlled foreign corporations (CFCs). The first extends an existing exemption for certain insurance and active financing income from subpart F that was previously set to expire. The second adds a new temporary exception from subpart F of the tax code for certain dividends, interest, rents and royalties received by one CFC from a related CFC, to the extent attributable to non-subpart F income of the payor.

Sections 951 through 964 of the Internal Revenue Code of 1986, as amended (the Code), subjects US shareholders of a CFC to current taxation on certain types of income (subpart F income) earned by the CFC. A US shareholder of a CFC must include in gross income its pro rata share of the CFC's subpart F income regardless of whether such income is actually distributed. A US shareholder is a US person who owns at least 10 percent of the voting stock of a foreign corporation. A foreign corporation is a CFC if US shareholders own more than 50 percent of its stock (by vote or value).

Foreign Personal Holding Company Income (FPHCI), a category of subpart F income, includes items of passive income such as dividends, interest, rents, royalties and annuities. The Code and the Treasury Regulations provide a number of exceptions from the definition of FPHCI, including an exception for income from the active conduct of a banking, financing, insurance or securities business (the active financing exception).

Subpart F Exception for Active Financing Income

Enacted as part of the original subpart F legislation, the exception for income from the active conduct of a banking, financing or securities business was repealed in 1986 and then reinstated in 1997. The exception for income from the active conduct of an insurance business was added to the Code in 1998. Both exceptions have been extended several times by Congress through the end of 2006.

The Act extends the active financing and insurance exceptions for two years, through tax years beginning before January 1, 2009.

Look-Through Treatment of Payments Between Related Controlled Foreign Corporations Under the Foreign Personal Holding Company Rules

Dividends, interest, rents and royalties derived by a CFC are generally included in FPHCI, subject to a number of exceptions. For example, there are exceptions for (i) dividends and interest received from a related corporation organized and operating in the same country as the payee CFC; (ii) rents and royalties received from an unrelated person in the active conduct of a trade or business by the CFC; and (iii) rents and royalties received from a related corporation for the use of property within the country in which the payee CFC is organized.

New Look-through Rule. The Act amends Section 954(c) of the Code by adding a new paragraph (6), which provides a look-through exception for payments of dividends, interest, rents and royalties between related CFCs to the extent that such payments are "attributable or properly allocable" to the income of the payor which is not subpart F income. The Act provides that, for this purpose, rules similar to the current look-through rules of the foreign tax credit regime, Sections 904(d)(3)(C) and (D), shall apply. This provision, effective for tax years of foreign corporations beginning after December 31, 2005 and before January 1, 2009, is a significant expansion of the current exceptions.

Corporate Spin-offs

Code Section 355 establishes rules governing "tax-free spin-offs." It generally provides that if a corporation (Distributing) distributes the stock of its controlled subsidiary (Controlled) to its shareholders, and the distribution otherwise meets the requirements of Section 355, Distributing and its shareholders will not recognize a gain on the distribution. The Act makes two potentially significant changes to Section 355. One simplifies the "active trade or business" requirement of Section 355. The other sets generous limits on a corporation's ability to distribute disproportionately large amounts of cash and marketable securities in what is commonly known as a "cash-rich split-off."

Simplification of the Active Trade or Business Requirement

Section 355(b) requires both Distributing and Controlled to be engaged in the active conduct of a trade or business immediately after the distribution. Under prior law, (1) each corporation was required to be engaged directly in that trade or business, or (2) immediately after the distribution, virtually all of the corporations' assets must have consisted of stock or securities of the corporation controlled by them that were so engaged. Various other detailed requirements existed for determining whether either requirement was met, often resulting in a technical trap for the unwary.

The Act modifies the "active trade or business" requirement by eliminating the distinction between directly and indirectly carrying on a trade or business. Each of Distributing and Controlled still must be engaged in a trade or business. The determination; however, will be made by treating each corporation's "separate affiliated group" as part of that corporation. A separate affiliated group is a chain of corporations with either Distributing or Controlled as the common parent, and includes any subsidiary of which the common parent owns directly, or indirectly through other members of the group, at least 80 percent of the total voting power and value of the subsidiary's stock.

Prohibition on Cash-Rich Split-Offs

The second change is intended to limit a corporation's ability to use Section 355 to "split off" a cash-rich subsidiary to a significant shareholder on a tax-free basis. It was included in the President's 2006 and 2007 budget proposal as a result of several high-profile split-offs that some commentators argued used Section 355 to avoid tax improperly on a transaction more properly viewed as a taxable redemption of stock.[1]

The Act adds new Section 355(g), which provides that Section 355 will not apply to any split-off if either Distributing or Controlled is a "disqualified investment corporation" immediately after the transaction and a person who holds a 50 percent or greater interest in the disqualified investment corporation immediately after the transaction did not hold a 50 percent or greater interest in the corporation immediately before the transaction. A disqualified investment corporation is a corporation in which the fair market value of the investment assets held by the corporation is two-thirds or more of the fair market value of all of the corporation's assets. In a somewhat unusual transition rule, the ceiling for investment assets in distributions occurring on or before the first anniversary of the Act is three-fourths instead of two-thirds.

Investment assets include cash, financial instruments such as options or derivatives, stock or securities of a corporation, and partnership interests. However, exceptions exist for assets used in the active conduct of certain financial trades or businesses or securities that are marked-to-market by dealers under Section 475. In addition, stock, securities and other financial instruments of corporations owned 20 percent or more by a potentially disqualified investment corporation—and partnership interests in and debt instruments issued by partnerships that carry on an active trade or business taken into account by the Distributing or Controlled corporation in satisfying the active trade or business test described above—will not be considered investment assets. Instead, the upper-tier corporation will look-through its interests in the corporation or partnerships and be treated as owning its ratable share of the lower-tier entity's underlying assets.

Effective Dates

Both changes to Section 355 apply to distributions occurring after May 17, 2006. However, the changes will not apply to distributions after the date of enactment that are (1) made pursuant to an agreement which was binding on the date of enactment and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before the date of enactment, or (3) described on or before the date of enactment in a public announcement or in a filing with the SEC. With respect to the active trade or business test, Distributing may make an irrevocable election not to have the above exceptions apply. Further, the provisions that modify the active trade or business test sunset on December 31, 2010.

Other Noteworthy Changes

Other provisions in the Act include:

(i) a change for payment of certain corporate estimated taxes;

(ii) the codification of proposed regulations under Code Section 163(j) that provide for the application of earnings stripping rules to corporations with respect to an interest in a partnership;

(iii) the modification of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) with respect to certain qualified investment entities that have significant interests in US real property and with respect to investors that do not own more than 5 percent of a qualified investment entity;

(iv) the repeal of both the FSC and ETI binding contract transition rule exceptions;

(v) changes to the section 911 housing exclusion;

(vi) extension of the 15 percent dividend and capital gains rate for individuals through December 31, 2010; and

(vii) the modification of the wage limitation for Section 199, by specifying that the limitation includes only amounts which are properly allocable to domestic production gross receipts.

The amendment to section 199 may be expected to delay, at least for a short time, the final section 199 regulations which were expected to be released by Treasury and the IRS in mid-May.

The Act makes a number of other changes to various individual, corporate and tax exempt entity related Code sections.

Endnotes

[1] Recent cash-rich split-offs noted in the Joint Committee of Taxation's 2005 report entitled "Options to Improve Tax Compliance and Reform Tax Expenditures" include Clorox Company's distribution to Henkel KGaA (cash representing 74 percent of the value of the distributed corporation), DST System, Inc's distribution to Janus Capital Group (cash representing 89 percent of the value), Houston Exploration Company's distribution to KeySpan Corp. (cash representing 87 percent of the value) and Liberty Media's distribution to Comcast Corporation (cash representing 53 percent of the value). *See* JCS-02-05 at 153-58. The President's 2006 and 2007 budget proposals would have set the ceiling for investment assets at 50 percent.

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